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The Consumer-Last Energy Bill

A Critical Look at the Consumer-First Energy Act of 2008

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The Consumer-First Energy Act of 2008 (S.2991), intended to address the energy crisis, fails to achieve its stated purpose. While it contains a few good ideas, it fails to implement those properly, and contains some very bad ideas that would make the nation's energy situation worse. The legislation relies on a failed command-and-control model, when liberalization would achieve much better results.

Title I: Tax Provisions Related to Oil and Gas. The Consumer-First Energy Act would impose the first windfall tax on American oil companies since 1980. The Bill Summary reads:

The Consumer-First Energy Act of 2008 would create a tax on “windfall profits” of the major oil companies at a special supplemental rate of 25 percent in 2008 and 2009. This tax would not apply to the windfall profits of oil companies invested in clean, affordable and domestically produced renewable alternative fuels, expanded refinery capacity and utilization, or renewable electricity production, which would all help lower consumers energy bills. The bill would also repeal the deduction for domestic production for the major oil and gas companies for their income on the sale, exchange, or other disposition of oil, natural gas, or any primary product thereof. Additionally, the legislation would also tighten the rule restricting the use of foreign tax credits on oil and gas related income. All revenue collected from the windfall profits tax and repeals of the tax deductions would be deposited into an Energy Independence and Security Act Trust Fund.

Two questions need to be asked: Would this work and is it justified?

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Would it work? The 1980 windfall tax on oil companies is generally regarded as a failure. It brought in a fraction of the expected revenues and was found by the Congressional Research Service to have discouraged production in domestic oil and gas.¹ Therefore, it was responsible for at least some of America’s “dependency” on foreign oil and gas. However, the 1980 tax was more of an excise tax than a tax on profits, imposed per barrel. The tax being currently proposed would likely have a neutral effect in the short run and would amount to a simple appropriation of profits by the government. However, in the long run, the Congressional Research Service found it would have a negative effect:

In the long run however, all taxes distort resource allocation and even a corporate profit tax (either of the pure type or the surtax on the existing rates) would reduce the rate of return and reduce the flow of capital into the industry, adversely affecting domestic production and increasing imports.²

Therefore, a windfall profit tax would likely increase America’s dependence on imported oil, while hindering American oil firms’ global competitiveness.

Is it justified? The purported reason for the windfall tax is the “excessive” record profits received by domestic oil companies. However, the absolute dollar amount is not the only measure of profitability. Oil companies are very large operations, so large profits are to be expected.

An important tool used by financial analysts to judge a company’s profitability is *return on capital*. Because oil firms have a large amount of capital invested in infrastructure and equipment, their return on capital could hardly be qualified as “excessive.” Petroleum refiners were only eighth in *Fortune* magazine’s table of business sectors for average return on assets in 2007, generating \$1.90 per \$1 of assets—well below health care wholesalers at \$3.91 or food and drug stores at \$2.78.³

Another tool for measuring profitability is *return on investment*, the return shareholders get for their money. Even here, petroleum refiners are nowhere near the top of the *Fortune* rankings, generating \$4.32 per dollar equity, in 14th place below a host of other industries—health care tops the list at \$11.98 per \$1 of equity.⁴ A high return on investment is good for any company, but it is also good for America, as it attracts foreign investment, which is itself turned into capital.

The real owners of major oil companies are not plutocrats, but ordinary Americans investing via their retirement plans. The Tax Foundation calculates that a windfall profits tax on oil companies would cost individuals who have invested wisely in companies that show a good return on investment up to \$585 a year in lost investment returns (which will of course compound up to retirement years, meaning a much greater loss in the long run).⁵ The only area in which petroleum refining tops the list is in revenues per employee, but this provides no justification for a profit tax. Moreover, the oil industry faces very high labor costs, as its employees earn the highest hourly and weekly wage of any sector measured by the Bureau of Labor Statistics (average hourly wage \$26.93).⁶

Renewables Exemption: The bill exempts firms from the windfall tax if they are ” “invested” in alternative energy projects. Virtually all domestic oil companies are so invested (see Annex for an extensive and representative list compiled by the American Petroleum Institute in 2005). Nevertheless, the bill decrees that this is not enough and seeks to direct companies’ research efforts for them. The only way to avoid the windfall tax would be to invest all of the profits that would otherwise be confiscated in these technologies, which would likely be a huge amount. This amounts to a nationalization of oil company research efforts. The inclusion of renewable electricity is particularly egregious, as oil is not a significant source of electricity generation.

Domestic Production Tax Deduction Repeal: Today, domestic production is hindered largely by regulation, most of it environmental. Repeal of the domestic production tax deduction alone would reduce domestic production by making it more expensive, and thereby increase dependence on foreign oil. Such a repeal would need to be accompanied by policies to encourage domestic production, such as lifting exploration restrictions in Alaska’s Arctic National Wildlife Refuge, the Outer Continental Shelf, and the Rocky Mountains. Technological advances allow for exploration and extraction with less impact on the environment.

This would also likely have an immediate downwards impact on the price of oil by relieving market worries about future supplies. As it stands, however, this provision is likely to reduce domestic production and increase the oil price.

Moreover, the removal of the exemption when significant subsidies for other forms of energy remain would represent another attempt by Congress to pick winners in energy technology. To allow market competition to help secure our energy future, these distortions should also be repealed.

Foreign Tax Credits: The bill would combine U.S. companies’ foreign oil and gas extraction income with their foreign downstream income and tax it all as extraction income, which is taxed at a high rate. This would increase the tax burden on U.S. companies trying to compete abroad, making them less competitive globally. Moreover, as America cannot fulfill all of its energy needs from U.S. production alone, this measure will cede many foreign energy resources to foreign state-owned oil companies, many representing hostile regimes. This could hurt U.S. national security in the long term.

Title II - Price Gouging. Posturing about “price gouging” is little more than a bogeyman which politicians use to frighten the American people to justify more powers for government—much like those in the rest of this bill.⁷ After the onslaught of hurricanes Katrina and Rita in 2005, the Federal Trade Commission found in its investigation of alleged price-gouging:

No evidence to suggest that refiners manipulated prices through any means, including running their refineries below full productive capacity to restrict supply, altering their refinery output to produce less gasoline, or diverting gasoline from

markets in the United States to less lucrative foreign markets. The evidence indicated that these firms produced as much gasoline as they economically could, using computer models to determine their most profitable slate of products.⁸

Title III - Strategic Petroleum Reserve. The Bill Summary reads:

The Bush Administration's policy of taking oil off the market and putting it underground in the Strategic Petroleum Reserve (SPR) is a contributing factor to current high energy prices. As the SPR's capacity already exceeds our International Energy Program commitments to maintain at least 90 days of oil stocks in reserve, it makes no sense to store oil underground when oil is trading at prices that have soared beyond \$120.

Title III would require the Secretary of Energy to suspend acquisition of petroleum for the SPR through 2008, including through the direct purchase or royalty-in-kind contracts. It allows the Secretary to resume filling if the price of petroleum falls to \$75 per barrel.

This is the best part of the bill, even as it does not go far enough. The amount of oil stockpiled in the Strategic Petroleum Reserve exceeds the statutory requirements. The bill should direct the Secretary of Energy to sell off that excess. The Reserve provides little economic benefit. Oil shocks are not as bad for the economy as once feared. When OPEC countries announced their 1973 oil embargo, U.S. crude oil imports increased from 1.7 million barrels per day (mbd) in 1971 to 2.2 mbd in 1972, 3.2 mbd in 1973 and 3.5 mbd in 1974.⁹ The 1970s oil shocks were caused not so much by the embargo as by the price controls and wage rigidities of the time. A 2005 Federal Reserve Bank of Cleveland study found that oil price increases do not cause inflation and that a doubling of oil prices would lead to a one-time increase in commodity prices of 3 percent—burdensome, but hardly catastrophic.¹⁰ Moreover, studies have shown that the existence of SPRs drive up the price of oil by as much as \$40-50.¹¹ The bill should repeal provisions for the Reserve and sell off the stock in its entirety.

Title IV - No Oil Producing and Importing Cartels. The Bill Summary reads:

Title IV of the Consumers-First Energy Act of 2008 would amend the Sherman Antitrust Act and allow the Attorney General to bring enforcement actions against any country or company that is colluding in setting the price of oil, natural gas or any petroleum product. Additionally, Title IV would seek to address OPEC state claims that their anti-competitive behavior has sovereign immunity from U.S. courts due to a court ruling in 1979. Title IV would not authorize private lawsuits against OPEC.

Antitrust regulation is a blunt instrument for curbing the power of OPEC. A better solution would be to allow antitrust exemptions for domestic oil companies that band together to act with greater power to break OPEC's current market dominance. Cartels normally collapse when there are significant forces pressuring members to "cheat" on the

cartel. At present, non-cartel members have nowhere else to go, but a viable contender to OPEC in the form of an organization of free-market oil companies could provide an alternative power bloc. It would be better to remove barriers to the market breaking the power of the cartel than attempting to use possibly ineffective or counterproductive litigation to do so.

Moreover, the legislation is likely to be ineffective. At a Senate Commerce Committee hearing on gasoline prices in May 2006, Federal Trade Commission Chair Deborah Majoras said of “NOPEC” legislation: “I don't think OPEC would respond to a lawsuit in the United States. I think they are going to laugh at it.”

Title V - Market Speculation. The bill contains two worrisome provisions relating to the regulation of oil commodity futures contracts and futures contract options.¹² The bill's authors argue that trading in these types of derivatives raises the price of oil.¹³ Collectively, the two provisions—both billed as “anti-speculation” measures—will likely harm the stability of oil supplies and drive capital from the United States without helping consumers or reducing oil prices.

First, the bill would ban “speculators” from routing oil-related trades through the IntercontinentalExchange (ICE) rather than the New York Mercantile Exchange (NYMEX). This is a bad idea for two reasons.

- First, it would remove an important level of regulatory competition from the oil trading market: Traders operating in the United States, under the law, would only be able to use one exchange.¹⁴ The result, over time, would be a regulatory regime that is less responsive to market realities.
- Second, since oil and money are both fungible, this would hinder American competitiveness, as non-U.S. players would then carry out the same strategies that had been proscribed in the U.S. As a result, the United States would see a net outflow of investment capital.

In addition, the bill would attempt to limit all speculation by increasing futures markets' margin requirements—the amount of cash that a trader must have in an account in order to borrow a certain amount to trade. This also should raise serious doubts for three reasons.

- First, market competition provides the best limit on margin trading. The money that a trader risks in a margin account belongs to private parties; it is these lenders, not the government, who lose if a trade goes bad.
- Second, all other things being equal, higher requirements will reduce individual traders' ability to purchase oil future contracts and thus the potential return on contracts. If this provision meets its goals and does actually reduce the amount of margin trading rather than simply drive capital out of the United States, it still will not do any good for consumers. Just as traders can bid up the price of oil, they can also bid it down. Generally, few traders, if any, care in which direction the price moves: Profits can be made from downwards volatility the same as from upwards volatility.¹⁵

- Third, if the amount of “speculation” falls, prices will *not* go down on average: At most, they may become more stable. While stability alone may have some use for those contemplating long-term business investment decisions, it has no real use for individual consumers. While long-term price trends can greatly impact consumer behavior, week-to-week price swings—the most that “speculation” could ever cause—are highly unlikely to impact consumer behavior. No consumer chooses when and whether to buy a new hybrid car based on small week-on-week price swings.

Traders who “speculate” by trading commodity contracts and options with no intention of ever exercising them serve a valuable purpose in bringing their collective, aggregated wisdom to prices in the commodities markets. This improves the quality of long range planning. Prices aggregate information more effectively than any other mechanism known. Speculation helps move supply into concert with demand. High prices encourage conservation much more effectively than any educational effort or government mandate ever could. The easy mobility of both oil and money make it impossible for any one nation’s laws to put an end to speculation in oil prices. Since this activity improves the accuracy of prices and carries information, this is not a bad thing. The provisions intended to reduce speculation will not reduce oil prices, but they will drive capital away from the United States.

Conclusion. The current energy crisis needs to be addressed by increasing the supply of energy worldwide. Instead, the proposed bill relies on punishment of energy suppliers who are themselves constrained by legislation in what they can do to increase supply. At a time when the nation is facing massively increased energy costs and income and credit availability are being squeezed, American citizens deserve better from their representatives in Congress.

Annex: Examples of Oil Companies Investments in Alternative Energy Research

Shell is constructing a wind farm power generating facility in West Virginia that will make it one of the world's largest generators of wind power.

ExxonMobil has developed super-thin plastic sheeting that can improve lithium-ion batteries for use in automobiles. With this technology, smaller, more affordable, safer and more reliable battery systems can be built that could greatly increase the attractiveness of hybrid electric and full electric vehicles.

Chevron Energy Technology Company has formed an alliance with the Penn State Institutes of Energy and the Environment to research coal conversion technologies. The joint research initiative will focus on coal chemistry and conversion technology, advanced fuels, combustion, analysis methods, reactor science, separations, process technology, and CO₂/greenhouse gas management and conversion.

ConocoPhillips is partnering with the Archer Daniel Midland Company to develop the capacity to make "biocrude," an energy source similar to crude oil made from switchgrass, wood, and crops.

Chevron Energy Solutions completed extensive upgrades to 16 Colorado state buildings that are expected to reduce energy costs at the facilities by 25 to 30 percent and save state taxpayers nearly \$1 million annually and more than \$20 million over the next two decades. By reducing energy use, the upgrades should also reduce carbon dioxide emissions by about 8,000 metric tons, equivalent to removing 1,500 cars from the road.

Chevron has started production of a 110-megawatt Darajat III geothermal plant in Garut, West Java, Indonesia. The combined output from Chevron's Darajat and Salak geothermal operations now produces sufficient renewable energy to supply approximately 3.9 million homes in Indonesia.

Chevron Energy Solutions and Bank of America are partnering with the San Jose Unified School District to establish what is expected to be the largest solar power and energy-efficient facilities program in K-12 education in the United States. The program, which will involve the installation of five megawatts of solar power, could save the district more than \$25 million in energy costs over its life.

BP Solar is doubling the size of its solar panel manufacturing facility in Maryland, the largest integrated solar panel manufacturing facility in North America, with an investment of nearly \$100 million. The company is also expanding solar plants in India and Spain.

BP, Associated British Foods, and DuPont are investing \$400 million for the construction of a world scale bioethanol plant alongside a high technology demonstration plant to advance development work on the next generation of biofuels.

Chevron is working with the Texas A&M Agriculture and Engineering BioEnergy Alliance to accelerate the production and conversion of crops for manufacturing ethanol and other biofuels from cellulose.

Shell Hydrogen LLC and Virent Energy systems, Inc. have agreed to develop further and commercialize Virent's BioForming™ technology platform for hydrogen production. The technology is expected to enable the economic production of hydrogen from renewable glycerol and sugar-based feedstocks.

BP and GE have formed an international alliance to advance and implement power plant technology that would reduce carbon dioxide emissions resulting from electricity generation.

BP has entered into a partnership with the University of California Berkeley and its strategic partners—the University of Illinois, Urbana-Champaign and the Lawrence Berkeley National Laboratory—to establish the Energy Biosciences Institute. The Institute will perform groundbreaking research aimed at probing the emerging secrets of bioscience and applying them to the production of new and cleaner energy, principally fuels for road transport. BP will invest \$500 million in the Institute over the next 10 years.

Shell Oil Products US and Codexis Inc, a biotechnology company, are launching a collaborative project to explore enhanced methods of converting biomass to biofuels. Clipper Windpower and BP Alternative Energy are cooperating in the development of five of Clipper's wind energy projects in the U.S. The projects are located in New York, Texas and South Dakota.

BP and GE are partnering to develop and deploy hydrogen power projects that will use fossil fuels to generate hydrogen power combined with carbon dioxide capture and storage. The first two projects will be in Scotland and California.

BP and Edison Mission Group, a subsidiary of Edison International, are planning a new \$1 billion hydrogen-fueled power plant in California that would generate clean electricity with minimal carbon dioxide emissions. BP is investing up to \$8 billion over the next decade in alternative fuel projects, including hydrogen, solar, wind, and gas-fired generation.

In renewable energy, Chevron has installed production capacity of 1,152 megawatts, primarily geothermal, making it the largest renewable energy producer of any global oil and gas company and the largest producer of geothermal energy. Geothermal is a renewable source of energy that uses the heat energy of the Earth to generate power with almost no greenhouse gas emissions. Chevron is involved in four major geothermal energy projects that produce clean electricity for Indonesia and the Philippines. If compared to a typical power grid (coal, oil, gas, etc.), this level of renewable energy production represents avoided greenhouse gas emissions of over 6 million tons annually.

Shell is the world's biggest blender of transport biofuels, with a stake in Iogen Energy that is testing new technology to make bioethanol cheaper using waste wood and straw, with carbon emissions 90 percent lower than for conventional fuels. The greenhouse gas emission reductions from cellulose ethanol are three times greater than those from grain-based ethanol on a life-cycle basis.

BP and the California Institute of Technology are conducting a multi-million dollar research program that could open the door to a radical new way of producing solar cells, making the cost of solar electricity more competitive and increasing current efficiency levels.

BP and DuPont are leveraging DuPont's world-class biotechnology and bio-manufacturing capabilities with BP's fuels technology expertise and market know-how to produce advanced biofuels. The first product to market will be biobutanol, which will be introduced in the United Kingdom as a gasoline bio-component.

In cooperation with the state of California, General Motors and Pacific Ethanol, Chevron is helping to evaluate a reformulated blend of E85 (85 percent ethanol/15 percent gasoline). Chevron will produce the renewable fuel at various demonstration stations for a fleet of 50 to 100 state vehicles.

Chevron has committed more than \$400 million a year to renewable and clean energy projects, including projects in wind and solar energy. The company is now operating wind farms or photovoltaic installations in the Netherlands, California, Guatemala City, London and Rio de Janeiro.

Chevron operates the largest, most complex hydrogen infrastructure in the United States. Chevron is leading DOE Hydrogen Demonstration projects, and in 2006 opened the Oakland, California AC Transit Bus Station, which uses hydrogen for city buses taking hundreds of passengers around Oakland. The company is working to open additional stations in Florida and Michigan.

Chevron has a joint venture with Energy Conversion Devices called Cobasys that develops advanced energy storage technologies by commercializing nickel metal hydride (NiMH) batteries for the emerging hybrid electric and fuel cell vehicles markets as well as non-automotive applications such as uninterruptible power supply for stationary and telecommunication applications. NiMH batteries are already used in today's hybrid-electric cars.

Chevron has formed a biofuels business unit to advance technology and pursue commercial opportunities related to the production and distribution of ethanol and biodiesel in the U.S. The company has invested in Galveston Bay Biodiesel LP (GBB), a Texas-based company that is building one of the first large-scale biodiesel plants in the United States, which will double the size of the amount of biodiesel being produced in the United States. The biodiesel will be made from soybeans and other renewable feedstocks. Chevron blends about 300 million gallons of ethanol per year for use in

gasoline blends and is participating in an E85 demonstration project with the state of California, General Motors, and Pacific Ethanol.

ExxonMobil is developing a novel technique for hydrogen production, potentially compatible with both on-board vehicle and larger-scale applications.

Notes

¹ Salvatore Lazzari, "The Crude Oil Windfall Profit Tax of the 1980s: Implications for Current Energy Policy," Congressional Research Service, March 9, 2006.

² Lazzari, *op. cit.*

³ "Top industries: Most bang for the buck," *Fortune*, May 5, 2008, <http://money.cnn.com/magazines/fortune/fortune500/2008/performers/industries/bangbuck/>

⁴ *Ibid*

⁵ Gerald Prante, "The Distributional Impact of Windfall Profits Taxes and a Gas Tax Holiday," Fiscal fact No. 127, Tax Foundation, May 2 2008

⁶ <http://www.bls.gov/news.release/empsit.t16.htm>

⁷ See Iain Murray, "Why Price Gouging Doesn't Exist OnPoint No. 113, Competitive Enterprise Institute, June 11 2007. <http://cei.org/pdf/5962.pdf>.

⁸ Federal Trade Commission Investigation of Gasoline Price Manipulation and Post-Katrina Gasoline Price Increases: A Commission Report to Congress (Spring 2006)

⁹ See Iain Murray, "A Free Market Approach to Energy Security," *OnPoint* No. 135, Competitive Enterprise Institute, April 17 2008

¹⁰ Charles T. Carlstrom and Timothy S. Fuerst, "Oil Prices, Monetary Policy, and the Macroeconomy," Federal Reserve Bank of Cleveland, Economic Commentary, July 2005.

¹¹ Jerry Taylor and Peter Van Doren, "The Case against the Strategic Petroleum Reserve," *Policy Analysis* No. 555, Cato Institute, November 21 2005.

¹² Futures are financial instruments that guarantee the delivery of a specific quantity of a commodity at a given price on a certain date and obligate the holder to purchase that commodity at that price. Options are similar instruments that give holders the right—but not the obligation—to buy these commodities. Corporations that use commodities—everything from frozen concentrated orange juice to oil—purchase futures to gain a degree of price certainty over time. Traders seek profits through trading them between their issuance and exercise dates.

¹³ The bill says: "Excessive speculation by financial traders, without adequate oversight and consumer protection, has likely increased energy prices for consumers. Today, speculators can avoid all U.S. market oversight or reporting requirements by routing their trades through the IntercontinentalExchange (ICE) in London instead of the NYMEX in New York."

¹⁴ See Jennifer Smith-Bozek, "Regulatory Competition: A Primer," *On Point* No. 128, Competitive Enterprise Institute, December 19, 2007, <http://cei.org/pdf/6319.pdf>.

¹⁵ Given the trend up generally upwards oil prices, indeed, those who want the price of oil to go down right now certainly stand to make the largest profits.